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SIPDIS

SENSITIVE

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BRUSSELS PASS TO STABILITY PACT - MIKE MOZUR

E.O. 12958: N/A
TAGS: ENRG ECON EFIN PGOV EIND SR MW
SUBJECT: NATURAL GAS CRISIS IN SERBIA HIGHLIGHTS PROBLEMS

Summary

¶1. (U) The recent gas shortage in Serbia highlights both deficiencies in its infrastructure and the perils of relying solely on Russian gas delivered through the Ukrainian pipeline. Both domestic and foreign companies that rely on natural gas supplies were negatively affected, and continued reliability problems could deter foreign investors who are major gas consumers. The Government of Serbia (GoS) plans to address the gas system's immediate needs with two infrastructure projects: a gas storage facility in Banatski Dvor and a new Nis-Dimitrovgrad gas pipeline. These will provide a supply from which to offset temporary shortages and alternative access to gas through Bulgaria. Carrying out such projects while both Gazprom and Hungary's MOL are seeking to strengthen their position in Serbia's energy industry will provide an interesting challenge for the Kostunica government. END SUMMARY

Gas Shortage's Adverse Impact

¶2. (U) On January 19, Russian company Gazprom announced that, due to extremely low temperatures in Russia, it would reduce by 25 percent the amount of gas delivered to a number of countries, including Serbia. However, temporary reductions lasted more than two weeks due to the Russia-Ukraine gas conflict and another cold wave at the beginning of February. The shortage left Srbijagas, Serbia's monopoly natural gas distributor, able to supply only priority customers - health institutions, schools and the food industry - while industrial facilities were forced to turn to other energy sources, such as coal, mazut, and electricity.

¶3. (U) However, most companies and city heating plants were not prepared. The price of mazut (a heavy oil left from the refining of higher value products) jumped from 14 to 20 dinars (approx. 27 cents) per kilogram, and it was cheaper to import electricity than to produce it from mazut. The electricity network was overloaded, although EPS, the state-owned power company, was able to avoid restrictions on consumers. A general lack of mazut coupled with the delay necessary to prepare boilers for mazut usage caused some cities like Nis and Zrenjanin to face two days of freezing weather without central heat. Meanwhile, both domestic and foreign companies suffered losses because of reduced gas deliveries.

¶4. (SBU) For instance, from January 19 to 28, US Steel Serbia's operations were severely disrupted by reduced deliveries from Srbijagas to its plants in Smederevo and Sabac. Six production units failed to meet January output targets due to the cold weather and gas reduction. Steelmaking, in general, is energy intensive, and US Steel consumes up to 40,000 cubic meters per hour. During this period, US Steel was receiving between 22,000 and 27,000 cubic meters per hour. This business interruption adversely impacted U.S. Steel's product shipments and financial results, causing millions in losses in January and February.

¶5. (SBU) However, despite pledges from Srbijagas that it would do everything possible to avoid more cuts to U.S. Steel, the company was notified on February 28 that it would face restrictions again. On March 1, the flow to U.S. Steel's Smederovo plant was cut from a range of 26,000-30,000 cubic meters to 18,000, and the reduction continued on March 2. Although the initial justification was colder weather, government officials revealed that Srbjiagas was giving preference (under GOS orders) to a state-owned fertilizer plant that consumes 10 percent of Serbia's gas on a daily basis. This plant normally is not permitted to operate during the winter, due to its impact on gas supplies. The plant also has not been able to pay for its gas on a current basis in the past. (The GOS is in the process of selling this plant, Azotera Panchevo, with a decision from the tender committee expected this week.)

¶6. (SBU)Following complaints by U.S. Steel, Ambassador Polt called Deputy Prime Minister Labus both on February 28 and on March 1, and he followed up with a call to Economy Minister Bubalo on March 2. Labus initially blamed the reductions on cold weather, then complained that U.S. Steel was not being forthcoming with information about its expected useage. Bubalo agreed that Srbijagas had been a problem this winter, but he said that Belgrade's municipal heating plant, not Azotera, was the reason for the more recent shortage. He pointed to the need to finish the underground storage by next winter to avoid such

problems. The Ambassador emphasized to both Ministers that such unpredictability seriously damaged not only the bottom line of a major U.S. investor, but also the reputation of Serbia among other current and future foreign investors.

Unreliable and Insufficient Gas Supplies

¶7. (U) Serbia's gas pipeline system suffers from its unenviable geographic position as the last customer at the end of a single pipeline, with the gas supply coming from Russia via Ukraine and Hungary. Serbia takes possession of its Russian gas at the Serbia-Hungarian border at Horgos, but pays for it at the Ukrainian-Hungarian border in Beregovo. Transit fees through Hungary are paid to Hungary's MOL.

¶8. (U) The agreed deliveries of Russian gas for 2006 are 10 million cubic meters per day, a level that is sufficient (allegedly) at projected temperatures of -15 degrees Celsius. But at lower temperatures, an additional 1.5 to 2 million cubic meters per day are necessary. For these additional supplies, Srbijagas must issue a tender, in which the price is much higher than the contract price. In addition, the transit pipeline has a physical limit of 10 million cubic meters per day. During the recent energy crisis, Serbia was receiving only 8.6 million cubic meters per day from Russia, allegedly due to unauthorized use of gas in Ukraine. Although Gazprom sought to maintain a steady supply or even increase gas deliveries to its European consumers, Ukraine was "stealing" some 70 million cubic meters per day, according to Gazprom executive Alexandar Medvedev, who cited this figure during his meetings in Belgrade on January 27.

¶9. (U) Hungarian MOL delivered to Serbia all of the gas Gazprom allocated to Serbia, although MOL received reduced supplies, as well. (NOTE: MOL managers told econ chief they were able to manage the shortage there without major disruptions.) Srbijagas is paying USD 220-230 per 1,000 cubic meters for the Russian gas, and the world price is around USD 270 per 1,000 cubic meters. In the contract with Gazprom, the gas price is not based on volume; rather, a methodology fixes the gas price at three-month intervals, depending on both the dollar and world oil prices. Srbijagas pays transit fees of approximately USD 25 per 1,000 cubic meters, about 10 percent of the gas price, to MOL.

¶10. (U) Serbia's annual consumption is around 2.7 billion cubic meters, which pales in comparison to consumption in the region, with Croatian consumption at 4.5 billion and Hungarian at 10 billion. Consumption is expected to increase by some 10 percent in 2006, while, at the same time, according to the 2006 Serbian Energy Balance, domestic production of natural gas in 2006 will be lower by some 14 percent, at 253.4 million cubic meters. Imports are expected to reach 2.568 billion cubic meters. Consumption is rising due to increasing gasification, and US Steel's reopening of a second blast furnace in Smederevo in 2005. Summer gas consumption is only 2.5 million cubic meters per day, while during the winter it exceeds 11 million cubic meters per day, more than 4 times higher.

Infrastructure Projects to Increase Reliability
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¶11. (U) A gas storage facility in Banatski Dvor and a Nis-Dimitrovgrad gas pipeline are two important investments seen as necessary for reliable gas supplies to consumers as well as for future development of Serbia's gas network. The Banatski Dvor facility requires around USD 65 million for phase one, and a total of USD 160 million for the entire project.

¶12. (U) The 167-kilometer gas pipeline, at a cost of around USD 65 million, will provide Serbia with an alternative route through Bulgaria, connected to the Russian gas system. This route also could provide a direct connection with the Nabucco project, a 3,300 kilometer pipeline sponsored by Austria's OMV, Turkey's BOTAS and others, that will bring Caspian and Middle Eastern gas into Western Europe via Turkey, Bulgaria, Romania and Hungary. Completion is projected for 2011. In addition, construction of the Nis-Dimitrovgrad pipeline would improve Serbia's prospects as a transit route for gas to some areas in Romania and Pristina.

¶13. (U) The Banatski Dvor gas storage facility will buffer summer-winter gaps in consumption and distribution, eliminate penalties to MOL because of this seasonal imbalance, and lower gas prices. Full capacity is projected at 850 million cubic meters and should be reached by 2011. However, since key equipment has already been imported from the U.S., the technical part of the first phase could be finished by late summer 2006. The biggest cost will be pumping in the fixed amount of gas - the so called "pillow gas" - that would 1) prevent underground water from entering the facility and 2) allow pumping of around 250 million cubic meters of gas next winter. Required investment for this technical part of the first phase is USD 15 million, and USD 50 million for the gas supplies. Once funding is secured, the storage facility could be finished by October-November 2006.

Russians and Hungarians Jockeying for Position
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¶14. (U) The Ukrainian gas controversy, Serbia's heavy dependence

on Russian gas, and Hungary's position as a crucial transit corridor, all create the perfect scenario to permit Gazprom and MOL to put pressure on the Serbian Government for prime positions in the forthcoming multi-million dollar investment projects.

¶15. (SBU) Serbia has a 20-year agreement with Hungary's MOL for gas transit from Russia which dates back to 1998. MOL CEO Zsolt Hernadi visited Serbia on January 25, just two days before the Gazprom visit. Knowing that Serbia plans to build an alternative gas route to Bulgaria, MOL's sought to strengthen its position in Serbia through a new agreement. Hernadi explained that MOL is very interested in building underground gas storage together with Srbijagas because Serbia's planned investments could affect gas prices and transport routes. A connection to the Bulgarian system would end MOL's monopoly on gas transit to Serbia. MOL would like a new agreement with Srbijagas, although the current one will not expire until 2018. After difficult negotiations, MOL and Srbijagas agreed only on an annex to the current agreement that will eliminate penalties for non-delivered gas from Russia. However, working groups will be formed to prepare for negotiation of a new agreement by the end of April 2006, which the Government of Serbia (GoS) wants to have in force starting January 2007.

¶16. (SBU) Negotiations with Gazprom's Alexandar Medvedev were held in Belgrade on January 27. The Russians placed the blame for the gas shortage on Ukraine's diversion of gas but pledged to try to maintain deliveries according to the contract in the future. Exploiting the political weakness of the current government and Srbijagas's current debt of USD 80 million toward Gazprom, the Russians lobbied for a privileged position in the forthcoming tenders for concessions to build the gas storage facility and pipeline.

¶17. (SBU) Citing two intergovernmental agreements between Russia and Serbia from the 1990's, Gazprom asserts that it has exclusive rights to build gas infrastructure in Serbia. These agreements established a joint venture company, Jugorosgas, in 1996 to manage the distribution of Russian gas and investment in gas infrastructure. The ownership structure of Jugorosgas was 50:50 between Gazprom and various Serbian companies (NIS, Sartid (now U.S. Steel Serbia), Progres-Beograd, Progresgas Trading, and Beobanka (does not exist anymore)). It was agreed that NIS would in time become the majority owner of Jugorosgas via preferential purchasing rights. However, when NIS was reorganized in October 2005, Srbijagas was left with only 25 percent in Jugorosgas while Gazprom bought 25 percent in Progresgas Trading to become the majority owner of Jugorosgas.

Public Tenders for Infrastructure Projects

¶18. (SBU) Econ officers met with General Director of Srbijagas Milos Tomic and Zorana Mihajlovic Milanovic, advisor to the Deputy Prime Minister for energy issues, at company headquarters in Novi Sad on February 6. Tomic confirmed that Gazprom is the majority owner of Jugorosgas, but denied that it has an exclusive right to build such gas infrastructure in Serbia. Milanovic explained that Srbijagas does not have sufficient funds to complete the necessary investment projects and said the GoS will issue public tenders for a strategic partner for these two investments. A public tender for the Nis-Dimitrovgrad gas pipeline concession should be expected sometime in autumn. The gas storage facility in Banatski Dvor will become a subsidiary of Srbijagas, and a strategic partner to finalize this facility will be sought through public tender no later than May or June 2006. In both cases, if Gazprom wins the public tenders, it will manage its operations through Jugorosgas.

¶19. (SBU) Tomic explained that borrowing for these projects was not feasible, because of Srbijagas's USD 80 million debt toward Gazprom. The current gas price of 16 dinars per cubic meter does not even cover production costs. Srbijagas's proposed price of 19 dinars per cubic meter would cover only production costs but leave nothing for investment. Srbijagas submitted the price increase to the Ministry of Energy and Mining, but, in effect, this requires approval not only of the Ministry of Energy, but also by the Ministries of Finance and Trade and Tourism. Finance Minister Dinkic generally has held up energy price increases to restrain inflation. It is possible that the GOS will act on this request after the winter.

Poor Management and Insider Deals

¶20. (SBU) Econoffs met with Assistant Minister for Public Enterprises Milutin Prodanovic (protect) at the Ministry of Energy on February 3, who laid partial blame for the energy crisis on new management at Srbijagas, as well as on unnecessary GOS intervention. Prodanovic said that similar gas problems with Russia occurred last year, but without complaints from the largest consumers in Serbia. According to Prodanovic, the new management, including General Director Tomic, an agronomist by profession, is inexperienced in gas and energy issues. After NIS was restructured into three independent companies (NIS, Transnafta and Srbijagas), leadership appointments to Srbijagas were awarded to the G17 Plus party, of which Tomic is a member. (Comment: Leadership positions as spoils for political parties are common in Serbia, often resulting in inexperienced or

incompetent individuals filling key jobs in state-owned companies.) Prodanovic also blamed Deputy Prime Minister Labus, leader of G17 Plus, for intervening in gas issues when it is not his responsibility. He also said that Zorana Milanovic Mihajlovic, Labus's energy adviser, lacks expertise.

Comment

¶21. (SBU) The good news in Serbia's continuing gas squeeze is that it could be easily fixed by relatively simple, inexpensive projects already on the drawing board. How skillfully the GOS maneuvers around its regional suitors and completes the work on-time and on-budget will provide a good test of its commitment to transparency and an improved investment climate. However, its handling of these issues so far, particularly with respect to U.S. Steel, has not been encouraging. We are concerned that the necessary projects are being structured as separate tenders with strategic partners - rather than simply borrowing the money, with a sovereign guarantee, if necessary - as a way to create opportunity for political payoffs. Given the high stakes for U.S. companies, and for Serbia, we will keep a close eye on these projects. END COMMENT.

POLT